

1987

A Perspective on Participant Loan Provisions in Qualified Retirement Plans After the 1986 Tax Act

Richard J. Kovach

Please take a moment to share how this work helps you [through this survey](#). Your feedback will be important as we plan further development of our repository.

Follow this and additional works at: <https://ideaexchange.uakron.edu/akrontaxjournal>

 Part of the [Tax Law Commons](#)

Recommended Citation

Kovach, Richard J. (1987) "A Perspective on Participant Loan Provisions in Qualified Retirement Plans After the 1986 Tax Act," *Akron Tax Journal*: Vol. 4, Article 7.

Available at: <https://ideaexchange.uakron.edu/akrontaxjournal/vol4/iss1/7>

This Article is brought to you for free and open access by Akron Law Journals at IdeaExchange@UAkron, the institutional repository of The University of Akron in Akron, Ohio, USA. It has been accepted for inclusion in Akron Tax Journal by an authorized administrator of IdeaExchange@UAkron. For more information, please contact mjon@uakron.edu, uapress@uakron.edu.

A PERSPECTIVE ON PARTICIPANT LOAN PROVISIONS IN QUALIFIED RETIREMENT PLANS AFTER THE 1986 TAX ACT

by

RICHARD J. KOVACH*

The Tax Reform Act of 1986¹ is the fourth major tax enactment in four years to have a significant impact on qualified deferred compensation plans. Like the Tax Equity and Fiscal Responsibility Act of 1982,² this most recent tax legislation substantially affects the use of participant loan provisions in qualified plans. The purpose of this article is to analyze the cumulative technical difficulties that retirement plan designers and administrators should now consider in reviewing the feasibility and operation of participant loan provisions.

I. GENERAL BENEFITS ASSOCIATED WITH PARTICIPANT LOAN PROVISIONS

The basic tax benefits resulting from qualified deferred compensation arrangements³ may be viewed as the reward granted in exchange for certain economic inconveniences incurred by both employers and employee-participants. Employers, of course, undergo the costs and administrative burdens embodied in the qualification criteria set forth in Section 401 of the Internal Revenue Code.⁴ Participants achieve their tax benefits, and hopefully some measure of retirement income security, at the expense of foregoing immediate economic enjoyment of the compensation deferred.

Participant loan provisions offer an apparent way to "have one's cake and eat it too," in that loan proceeds can provide an immediate economic benefit even though the participant's net economic worth is not increased as a result of borrowing. The actual existence and value of such immediate economic benefit can be determined only by considering the extent and terms of potential alternate sources of credit available to the borrower. An examination of such alternate sources could conceivably lead many plan participants to regard

* Professor of Law, The University of Akron School of Law; A.B. Oberlin College, 1970; J.D. Harvard Law School, 1974.

¹Pub. L. No. 99-514, 100 Stat. 2085 (1986).

²Pub. L. No. 97-248, § 236(a)(2)(A)(i), 96 Stat. 324, 510 (1982), as a practical matter limits plan loans to no more than \$50,000 per participant.

³Generally, qualified deferred compensation systems permit deferral of income recognition to participants even though the employer is permitted an immediate deduction, while also permitting deferral of income recognition on the earnings from contributions, potentially favorable distributions taxation rates, and, in some cases, avoidance of federal employment taxes on deferred income.

⁴This and all subsequent references to the Internal Revenue Code refer to the Internal Revenue Code of 1986. Subsequent footnote references will be expressed in the form "I.R.C. § ___."

their plan loan provisions as being virtually worthless.⁵

Absent such a comparison with alternate sources of credit, the basic tax mechanics that govern loans made to participants of qualified plans give the appearance that loan provisions always work to the participant's advantage, since the interest paid to the plan's trustee may be deductible under Internal Revenue Code (Code) Section 163⁶ even though received by the plan's trustee (and reinvested with tax deferred returns) for later distribution to the borrower, perhaps under favorable tax circumstances.⁷ Plan loan provisions are thus commonly viewed as a way to "borrow from oneself" in a tax-favored manner.

Indeed, hypotheticals can be constructed to illustrate how plan loans interact with other tax-benefited transactions in order to compound overall tax savings to a surprising degree. For example, a closely-held business owner-employee might be impressed by the tax posture created from the following series of transactions: a tax-deductible cash contribution is made to a qualified retirement plan and allocated to the owner-employee's account in the plan; the owner-employee repossesses the cash contribution by borrowing, without imposition of taxes, from his account pursuant to a properly observed loan provision in the plan; the loan proceeds are used to purchase an automobile, piece of equipment, or other item ostensibly useful to the owner-employee in the conduct of his business and therefore subject to additional tax benefits such as depreciation, amortization, or cost recovery deductions.⁸

Of course, the tax advantages resulting at each step of such a hypothetical are available independently of the combination of steps and therefore exist whether the financing is achieved through a plan loan or through a loan from an independent source such as a commercial lender.⁹ Although the overall "tax magic" associated with plan loans appears formidable, borrowing outside the qualified plan does not alter a given pattern of tax benefits. This proposition can be illustrated with an example based on the following assumptions: The participant can borrow a designated amount pursuant to exactly the same

⁵The perceived value of a loan from a qualified plan to a participant who can exert some influence toward the determination of the terms of credit extended to him may be greater than that afforded a rank and file employee. However, the improper exercise of such influence may adversely affect the plan's qualification status or otherwise cause detrimental tax consequences. See *infra* notes 38-61 and accompanying text.

⁶Limitations on interest deductions under the Tax Reform Act of 1986 are discussed *infra* text accompanying notes 107-23.

⁷The loan proceeds are not themselves taxable to the participant, since creation of the offsetting debt means that the participant realizes no "undeniable accessions to wealth" that can be taxed under I.R.C. § 61. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 75 S. Ct. 473 (1955). The potentially favorable tax climate at the time of distribution might include lower tax rates than were applicable at the time the deferral was initiated or qualification for rollover treatment, five-year forward income averaging, or ten-year forward income averaging under I.R.C. § 402.

⁸Prior to 1986, the scenario of tax benefits could have been spiced up with an investment tax credit, no longer available as a result of the Tax Reform Act of 1986.

⁹Regardless of whether the credit is obtained from a qualified plan or a commercial lender, the borrower avoids taxation only by repaying the loan from his current or future assets. Failure to repay a plan loan can convert it into a taxable distribution under I.R.C. § 402. Failure to repay a loan taken from a commercial lender might result in income recognition from discharge of indebtedness under I.R.C. § 108.

terms from either his qualified plan or a commercial lender; the commercial lender is also the plan's trustee, which holds and invests all of the plan's assets in interest bearing certificates of the lender; interest paid by participants on plan loans is credited solely to the borrower's plan account;¹⁰ assets not loaned are invested in instruments having a maturity period equivalent to the repayment term given for plan loans.¹¹

Under the above assumptions, the only economic advantage that could be derived from a plan loan over a non-plan loan would result from a potential difference between interest charged on a non-plan loan and interest paid on the participant's behalf under the terms of the plan's investment certificates. This difference would represent in effect the lender/trustee's gross profit margin derived from its market and regulatory ability to loan money at interest rates higher than those paid to depositors. It is, in the case of the participant who borrows against his own plan account, value that inures to the participant's own benefit rather than to the benefit of the lender/trustee.¹²

If no such difference between interest charged and interest credited exists, the borrower realizes no economic advantage by taking a loan from his plan, secured with his account balance, rather than borrowing from outside sources. In either case, the borrower obtains the use of the loan proceeds (either to consume or enhance his net worth, or both), the borrower is obligated to pay back the loan in full with interest that may be deductible, and both before and after the loan is repaid, the borrower's net worth is the same.¹³

If one could borrow from an outside source at a rate of interest equal to or less than the rate of investment return to be earned on plan funds left intact, borrowing such funds from the plan would produce no economic benefit to the borrower. Accordingly, the primary economic analysis to consider when evaluating the benefit of loan provisions involves a comparison of outside credit terms with the potential investment productivity of funds left unborrow-

¹⁰This is a common practice in defined contribution plans. Conceptually, however, a participant loan represents an investment of assets held by the trustee for the collective benefit of all plan beneficiaries. Should the return realized on such investment be shared pro rata by all plan participants? To resolve this question and the potential fiduciary implications it raises, the plan document for a defined contribution plan should specifically authorize the crediting of interest from a participant loan to the borrower's individual plan account.

¹¹Most participant loans will have a repayment period of no more than five years as a result of I.R.C. § 72(p)(2)(B).

¹²For example, if the commercial lender would grant a five-year loan for a specific purpose at 10% interest while paying 7½% interest on its five-year certificates of deposit, the 2½% difference becomes the economic advantage that would inure to the benefit of a participant who borrows against his plan account rather than directly from the commercial lender.

¹³By borrowing from his plan account all transfers of value connected with the transaction, involving both principal and interest, occur between elements of the participant's own net worth. Outside borrowing involves transfers of value to the lender from the borrower's net worth, but the net economic effect of such transfers is determined by the difference, if any, between interest payments made to the lender and investment earnings that would have been realized upon the portion of the borrower's accrued benefit that would otherwise have been used as a source of loan proceeds.

ed in the qualified trust.

Obviously, if borrowing from an outside source is not possible but borrowing from a qualified plan is, using the plan as a source of credit might itself constitute an economic benefit to the participant.¹⁴ Thus, it is possible that one might achieve some economic benefit by using a plan loan as a means to maximize secured borrowing. Normally, an outside lender would not look to a borrower's interest in a qualified retirement plan as collateral security, since Code Section 401(a)(13) restricts the availability of such to general creditors.¹⁵ If non-plan assets were already serving as collateral security to the maximum extent, a plan loan could permit additional secured borrowing.¹⁶

Aside from these fundamental economic considerations, the utility of loan provisions in qualified plans might best be evaluated with reference to the potential convenience to participants such borrowing entails. Although commercial lenders increasingly attempt to streamline their lending procedures and make borrowing as painless as possible, the average consumer might still find additional comfort in borrowing "at work" from a truly familiar source of credit. However, any potential convenience to employees must be weighed against considerable administrative inconveniences to be borne by the employer or other plan administrator who undertakes full and proper implementation of a plan loan provision.¹⁷

II. TECHNICAL PROBLEMS REMAINING FROM THE REGULATION OF PLAN LOANS PRIOR TO THE 1986 TAX ACT

Qualified plan loan provisions are basically subject to four categories of legal regulation: non-tax state and federal rules that apply to broadly defined debtor-creditor relationships; prohibited transaction and fiduciary responsibility rules of the Economic Retirement Income Security Act of 1974 (ERISA);¹⁸ plan qualification rules that permit participants in various kinds of deferred compensation plans to enjoy specific tax benefits;¹⁹ and distributions taxation rules set forth in Code Section 72. Each of these categories of regulation create

¹⁴Although if a participant cannot borrow from commercial lenders, the poor credit standing of the participant might also preclude borrowing from the plan, since the plan administrator may be viewed as having a fiduciary responsibility to forego loans that involve a substantial risk of not being repaid.

¹⁵I.R.C. § 401(a)(13) specifically does not regard as a prohibited assignment or alienation a plan loan secured by the participant's accrued nonforfeitable benefit as long as the loan conforms with the prohibited transactions exemption of I.R.C. § 4975(d)(1).

¹⁶See *infra* text accompanying notes 38-61 regarding problems resulting from the use of the participant's vested accrued benefit as security for a plan loan.

¹⁷Although many plan loan provisions originate prior to 1982, when owner-employees could borrow amounts far exceeding the practically imposed \$50,000 limitation of I.R.C. § 72(p), in some instances employee expectations may result in the continuance of loan provisions through successive plan amendments, even though the utility of plan loans to owner-employees continues to diminish while administrative burdens connected with plan loans continue to increase.

¹⁸Pub. L. No. 93-406, 88 Stat. 829 (1974).

¹⁹I.R.C. § 401(a) lists the qualification criteria for stock bonus, pension, and profit-sharing plans.

special problems of concern to plan administrators and advisors who deal with plan loan provisions.

A. *Non-Tax Regulation*

Plan loans are similar to any other kind of credit arrangement in that a formal debtor-creditor, contractual relationship is created between two parties (the participant-borrower and a fiduciary-lender). Under local law this contractual relationship will involve certain enforceable rights and duties. To avoid ambiguities, omissions, misunderstandings, and the like, the rights and duties intended by the parties should be clearly expressed in an appropriate written instrument or instruments.²⁰

Failure to observe the formalities embodied in a written instrument can lead to both tax and non-tax difficulties. In small plans the typical problem is a failure to execute even a simple promissory note. In the tax context, lack of a written instrument can lead to the issue of whether the payment from the trustee was actually loan proceeds rather than a taxable distribution from the plan.²¹ A non-tax problem might also arise, for example, if the participant were to die or otherwise have trouble fulfilling the intended terms of repayment. With no formal evidence of indebtedness, the trustee will face questions, among others, respecting the proper rate of interest to apply in determining an accurate loan balance for purposes of offset against the participant's accrued benefit. A dispute with the participant, or his heirs or representatives in the death situation, may arise. Attempts to resolve such difficulties via execution of back-dated instruments most likely only create additional (ethical) problems that also personally involve the plan fiduciaries and their advisors.²²

Larger plans usually use at least one written instrument, so the focus for such plans is on the clarity and completeness of the instruments used. The following is a listing of loan agreement provisions that serve to clarify the rights and duties of the parties or facilitate easier administration of loans: definitions of basic language terms, such as "vested" or "non-forfeitable interest," "account balance," "loan limit," etc.;²³ explanation of the interest computation method and the effect of early payment; listing of events that con-

²⁰Often the understandings of the parties to a plan loan will be manifested in the same manner as commonly practiced by commercial lenders — through execution of both a loan application document and a promissory note.

²¹Even if the parties clearly intended a loan, lack of a written instrument calls into question the terms of the loan. If the terms of the loan are vague, they may not conform with the limitations of I.R.C. § 72(p) and thus result in taxability to the participant in any event. For example, without a written instrument the participant may not be able to show that the loan was to be repaid within five years, as required of many loans under I.R.C. § 72(p)(2)(B).

²²Obviously, later execution of documents creates special problems if the participant has since died.

²³Some definition provisions will set the tone for easier reading throughout the document by identifying the borrower with the terms "I," "me," and "my," and the plan administrator or trustee with the terms "you" and "your."

stitute default;²⁴ explanation of any demand feature operative upon default; identification of the security interest taken by the lender, sometimes to include an interest in property of the participant not held by the trustee when necessary;²⁵ identification of which party is to bear various collection costs that may be incurred in the event of default; explanation of the effect (or lack of effect) of any delay in enforcement; explanation of the tax consequences to the participant resulting from default;²⁶ explanation of the trustee's right to accept irregular payments without affecting the rights and duties of the parties; identification of the use to be made of the loan proceeds;²⁷ authorization for the lender to proceed first against the participant personally before realizing upon its security interest;²⁸ authorization for payroll withholdings by the employer pursuant to the agreed repayment schedule.

This latter provision can avoid the many administrative problems resulting from nonpayments that might otherwise occur, as well as help the participant avoid the unplanned tax burden of a deemed distribution upon loan default. Without an express authorization from the employee, the employer might not be able to assert successfully that the existing contractual employment relationship implicitly permits the employer to act on behalf of the employee's plan loan creditor, leaving the employer open to claims asserting improper diversion of the employee's earned and payable compensation. Of course, the administrative difficulties stemming from collection or security realization can appear in any event if a participant defaults at or after the time he terminates employment.²⁹

In addition to provisions delineating discretionarily determined rights and duties, loan agreements subject to the Federal Truth in Lending Act³⁰ must

²⁴Events constituting default might include, for example, the participant's voluntary termination of employment while maintaining an unpaid loan balance.

²⁵As discussed *infra* text accompanying notes 55-56, the participant's vested accrued benefit may not by itself always be adequate security for a plan loan.

²⁶Reminding participants that unrepaid loans may be treated as taxable distributions serves as encouragement toward timely repayment for those who believe they are only "borrowing from themselves."

²⁷The use of the proceeds is linked to the permissible term of the debt under I.R.C. § 72(p)(2)(B) and assists in determinations of interest rates (commercial lenders often vary interest rates according to the purpose for which the loan proceeds are used) and whether security in addition to the participant's accrued benefit exists.

²⁸If the debt can be collected without resorting to realization upon the participant's accrued benefit security, the plan administrator can help the debtor-participant avoid a taxable distribution.

²⁹To avoid default upon termination of employment, the plan administrator may want to consider use of a payroll withholding authorization that permits withholding from a final or severance pay in amounts greater than a loan's normal periodic payment amount.

³⁰15 U.S.C. § 1601 (1976). Regulation Z, 12 C.F.R. § 226.1(c) applies the Truth in Lending Act to extensions of credit regularly offered to consumers for personal, family, or household purposes when the credit is subject to a finance charge or is payable by a written agreement in more than four installments. 12 C.F.R. § 226.2(17) states that "regularly" means the extension of credit more than twenty-five times (or more than five times for transactions secured by a dwelling) in a defined calendar year. 12 C.F.R. § 226.3 exempts from regulation extensions of credit primarily for a business, commercial, or agricultural purpose and extensions of credit over \$25,000 not secured by real property or a dwelling. Pursuant to these definitions and exemptions not all plans making participant loans will be subject to the Truth in Lending Act. A plan administrator should, of course, examine these criteria to see if plan loan documents should contain the required disclosures.

contain certain mandatory designations — cost of credit expressed as a yearly rate; the dollar amount the credit will cost the borrower; amount of credit provided to the borrower; total amount to be paid after all payments are made as scheduled; payment schedule and due dates.³¹

State usury laws should also be consulted by administrators of retirement plan loan provisions. For example, Ohio sets a general limitation on interest for a promissory note at eight per cent per annum.³² A violation of this limitation results in the legal crediting of interest in excess of the eight per cent rate to principal.³³ The Ohio statute, in order to facilitate normal consumer and business credit transactions, provides a number of exceptions to the eight per cent rule.³⁴ Thus, higher rates can be legally charged, among other exceptions, when the loan is secured by qualifying real estate³⁵ or when the instrument is payable on demand and is not secured by goods used for personal purposes.³⁶ Since the usury rate in Ohio, or other jurisdictions, may not always fit within the definition of a “reasonable rate of interest” in the prohibited transaction rules of ERISA,³⁷ attention should be directed toward drafting loan procedures that conform with specific usury statute exceptions.

B. *Prohibited Transactions and Fiduciary Responsibility Regulation*

ERISA Section 406 and Internal Revenue Code Section 4975 both prohibit various transactions involving retirement plans, including loans from a plan to a participant.³⁸ Violations of ERISA Section 406 can cause the responsible fiduciary to be personally liable for any potential detriment to the plan caused by the prohibited transaction and subject the parties involved to appropriate equitable or remedial relief.³⁹ Violations of Code Section 4975 can

³¹The precise disclosure requirements for extensions of closed-end credit governed by the Truth in Lending Act are set forth in 12 C.F.R. § 226.17.

³²OHIO REV. CODE ANN. § 1343.01 (Baldwin 1986).

³³*Id.* § 1343.04.

³⁴*Id.* § 1341.01(B).

³⁵*Id.* § 1343.01(B)(4).

³⁶*Id.* § 1343.01(B)(5).

³⁷The “reasonable rate of interest” requirement, expressed in I.R.C. § 4975(d)(1)(D), is discussed *infra* notes 38-61 and accompanying text. Even though a plan administrator sets a “reasonable” interest rate as contemplated by ERISA and ERISA § 514(a) states that state laws relating to employee benefit plans are superseded by ERISA, a claim brought under a state usury law, perhaps by a departing employee or the estate or heirs of a deceased employee, might have support either by virtue of ERISA § 514(b)(2)(A), which exempts from preemption state laws that regulate banking, or as a result of more general arguments that disfavor preemption and that are usually based on findings that the state law in question does not really “relate to any employee benefit plan.” Such a finding might be easier to make in a usury litigation when the rate charged, although within ERISA’s permissible range of reasonableness, is at the high end of the range, while selection of a rate farther down the range of reasonableness would have conformed with state usury law requirements. No doubt the safest course for a plan administrator, if possible, would be to select rates that are both reasonable under ERISA and in compliance with state usury laws.

³⁸Prohibited transaction violations were deemed a subject of both Labor Department regulation and tax regulation. Thus, two quite similar but not identical statutes govern prohibited transactions.

³⁹ERISA § 409(a).

result in imposition of a five percent excise tax, based on the amount involved in the prohibited transaction, against any "disqualified person"⁴⁰ who participates in the prohibited transaction.⁴¹

ERISA Section 408(b)(1) and Internal Revenue Code Section 4975(d)(1) provide exemptions to the respective prohibitions against participant loans if identical criteria are met: loans must be available to participants on a reasonably equivalent basis; loans cannot be made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees; loans must be made in accordance with specific provisions set forth in the plan; loans must bear a reasonable rate of interest; and loans must be adequately secured.

The first two of the above requirements for exemption are suggestive of the anti-discrimination qualification criteria of Code Section 401(a) and thus regulate violations that also have a potential for plan disqualification as well as prohibited transactions impositions.⁴² Obviously, violations of these rules might occur as a result of *de facto* discrimination in a plan's operation even though the language of the plan purports to grant loans in a uniform, non-discriminatory manner. Unfortunately, neither ERISA Section 408(b)(1) nor Code Section 4975(d)(1) contain a provision analogous to Code Section 401(a)(5), which permits plan contributions or benefits to bear a uniform relationship to participants' compensation. Thus, loan provisions that permit borrowing only up to dollar limits expressed as a percentage of a participant's compensation appear to be discouraged.

Because of the distributions taxation rules imposed on plan loans under Code Section 72(p),⁴³ plan loan provisions typically limit loan amounts according to the size of a participant's nonforfeitable accrued benefit. For this reason, it is possible (perhaps even likely) for such plans to make loans available to "prohibited group"⁴⁴ employees in an amount greater than the amount made available to other employees when the prohibited group employees have substantially larger vested accrued benefits than those of rank and file employees. Since any problem arising from such circumstances would be operational, and not just a matter to be determined with reference to mere plan language, determination letter approval of loan provisions designed with the Code Section 72 limitations in mind does not serve as a resolution.⁴⁵ Presumably, however, such

⁴⁰I.R.C. § 4975(e)(2) defines "disqualified person" as including employer-owners, officers, and others who might also be plan participant-borrowers.

⁴¹I.R.C. § 4975(b) increases the excise tax to 100% of the amount involved for failure to correct a prohibited transaction in a timely manner.

⁴²See *infra* text accompanying notes 62-68.

⁴³See *infra* text accompanying notes 69-79.

⁴⁴Under the Tax Reform Act of 1986 the "prohibited group" concept has been replaced with the concept "highly compensated employee" as defined in I.R.C. § 414(q).

⁴⁵Determination letters for qualified plans typically refer to the effect of the plans under the Internal Revenue Code in general, which presumably means that the plans on their face do not violate I.R.C. § 4975 or I.R.C. § 401(a). However, operational disqualification can occur despite a favorable determination letter

a potential problem is less likely to attract attention if disparities in vested accrued benefits are attributable to permitted vesting and benefit accruals under Code Sections 411 and 401(a)(5) respectively.

The Code Section 4975(d)(1) exemption requirement that loans be made only in accordance with specific plan provisions makes it clear that a prohibited transaction occurs anytime a participant borrows from a qualified plan not having a loan provision, even if the borrowing clearly does not result in a taxable distribution under Code Section 72 or affect the plan's qualification under Code Section 401(a). Exactly what constitutes a "specific" loan provision for prohibited transaction purposes is not clear, but a draftsman would be well advised at least to set forth the five Code Section 4975(d)(1) exemption requirements, in addition to the Code Section 72(p) criteria needed to avoid taxable distributions, as well as incorporate by reference any ancillary lending rules, definitions, and other information separately appearing in print.⁴⁶

The "reasonable rate of interest" requirement of Code Section 4975(d)(1) presents a very practical problem for plan administrators, since various participants may strongly desire that the interest rate on plan loans be either unreasonably low or unreasonably high. The participant who views the plan loan as a mere alternative to borrowing from commercial lenders may care little about the contribution to retirement income security made by the interest return on such loans and thus simply focus on the immediate cost of credit. The participant who views plan loans as a sort of tax gimmick may, to the contrary, deliberately wish to borrow with as high as possible an interest rate in order to maximize what might be perceived as tax deductible⁴⁷ voluntary contributions disguised as interest payments.⁴⁸

The plan administrator, of course, should not accede to either way of thinking, if he is to avoid a prohibited transactions problem.⁴⁹ However, the plan administrator may have the discretion to choose a lower or higher rate of interest within an acceptable range of "reasonable" rates and thus potentially favor one loan "philosophy" over the other, presumably as long as doing so does not work a demonstrable discrimination in favor of the Code Section 401(a)(4) prohibited group.⁵⁰

respecting a variety of I.R.C. § 401(a) issues, so a favorable determination letter clearly offers no protection against operational violations of I.R.C. § 4975.

⁴⁶Incorporation by reference of existing loan application and promissory note forms would be appropriate.

⁴⁷See *infra* text accompanying notes 107-23.

⁴⁸The participant's view in this regard would be predicated upon the plan's crediting interest paid solely to the borrower's own account balance.

⁴⁹Also, setting the interest rate too high could create a qualification issue under I.R.C. § 401(a) since the excess amount could be deemed in substance an employee contribution, possibly in violation of the 10% of annual compensation limit placed on such by the Service. See Rev. Rul. 350, 1980-2 C.B. 133. See also I.R.C. § 401(m) (1986).

⁵⁰Presumably, the prohibited group would be more likely to desire higher interest rates than rank and file employees. Indeed, some in the prohibited group might view high interest rates as a means to limit borrowing by the rank and file group.

A range of reasonable rates might be determined from an objective survey of interest rates charged by commercial lenders in the community for various types of loans.⁵¹ Absent such data, the plan administrator might seek to resolve the rate determination problem by referring to a single objective source of interest rates, such as a published "prime rate,"⁵² the "applicable federal interest rate" defined in Code Section 1274(d)(1)(A),⁵³ or some other rate determination applicable for federal tax purposes.⁵⁴

The requirement of Code Section 4975(d)(1) that loans to participants must be adequately secured will be met in most cases by using the participant's accrued benefit as security. In many cases the restrictions that must be observed under Code Section 72(p) in order to prevent taxation to the borrower upon granting a loan will ensure that adequate security exists for larger loans up to \$50,000, since the participant's nonforfeitable accrued benefit usually will be twice the amount borrowed.⁵⁵ However, the rules of Code Section 72(p) permit nontaxable loans of up to \$10,000, irrespective of the size of the participant's vested accrued benefit.

Consequently, the adequacy of the security afforded by a participant's vested interest in a plan may fail from the outset if the plan permits loans up to \$10,000 that exceed the value of such interest. Indeed, even if the participant's loan does not exceed his vested accrued benefit at the time the loan is made, subsequent events, such as interest accruals upon default or a market devaluation of plan assets,⁵⁶ may cause a security deficiency. For this reason, it may be advisable to include as part of a loan's terms a provision permitting the trustee or plan administrator to acquire additional security for a plan loan as needed. Alternatively, a provision requiring accelerated payment upon a determination of inadequate security may be useful. Of course, taking security beyond the vested plan interest of the borrower entails various potential legal and ad-

⁵¹Sometimes the business sections of local newspapers will periodically publish commercial loan rates for an area.

⁵²Plan loan rates are sometimes determined on an adjustable "prime plus" basis just as for commercially given loans.

⁵³Using the applicable federal interest rate would avoid any potential tax recharacterization of a below market rate loan under I.R.C. § 7872. A qualified trust does not have to pay taxes on interest received regardless of an I.R.C. § 7872 recharacterization. However, I.R.C. § 7872(a)(1)(A) will treat foregone interest as having been transferred from the lender to the borrower. Could such treatment result in a tax consequence to a plan participant-borrower? I.R.C. § 7872(c) states that applicable below-market loans include compensation-related loans involving "indirect" as well as direct borrowing between an employer and an employee. I.R.C. § 7872 also covers "tax avoidance loans" and "other below-market loans" that "have a significant effect on any Federal tax liability of the lender or the borrower." I.R.C. § 7872(c)(1)(D)-(E). Since many species of interest are no longer deductible under the 1986 Tax Reform Act, the deemed retransfer of foregone interest by the borrower to the lender frequently will not permit an offsetting tax advantage against a taxable deemed transfer from the lender to the borrower.

⁵⁴Note the manner in which interest rates for tax underpayments and overpayments is determined under I.R.C. § 6621.

⁵⁵I.R.C. § 72(p)(2)(A).

⁵⁶A loan itself, as a plan asset, may be devalued if prevailing interest rates rise substantially after the loan is granted.

ministrative problems.⁵⁷

In view of such potential difficulties, the plan's fiduciaries might well desire that their loan provision permit borrowing only when a comfortable margin exists between the amount borrowed and the value of the borrower's vested plan interest. Although such an individually-designed restriction would purportedly apply uniformly to all participants, in fact, rank and file participants might be at a disadvantage compared to higher-paid participants if the latter tend to have disproportionately greater vested accrued benefits. Such a circumstance might call into question the plan's qualification status.⁵⁸

In addition to examining the prohibited transactions exemption criteria applicable to plan loans, plan administrators should consider the fiduciary responsibility rules of ERISA.⁵⁹ Generally, those involved in the administration of plan loans must act in the exclusive interest of plan participants (and their beneficiaries) and with the care, skill, prudence, and diligence that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of a similar enterprise.⁶⁰

In light of this standard, the following are some questions a plan fiduciary might consider in implementing and administering a loan program: Even though a proposed loan would be adequately secured by the borrower's plan interest, should loan approval be denied, so as to assist in the preservation of the participant's retirement income security, if it appears that the borrower will have difficulty effecting repayment? Should plan loans be permitted at all if committing assets to loans results in more restricted investment opportunities for remaining assets? Should plan loans alternatively be encouraged or discouraged depending upon a comparison of reasonable lending rates with prevailing rates of return on non-loaned plan assets? Should the loan provisions of a defined contribution plan contain specific language allowing the direct crediting of loan repayments and interest to the segregated account of the borrower?⁶¹

C. Regulation Via Plan Qualification

The preceding discussion refers to instances when plan loan provisions might operate to the greater advantage of prohibited group personnel and thus evoke a potential qualification inquiry under Code Section 401(a)(4). Although

⁵⁷For example, local recording statutes and foreclosure procedure may have to be observed.

⁵⁸I.R.C. § 401(a)(4), it should be argued, is not violated as long as the disparities in vested accrued benefits are due to the proper application of I.R.C. § 411 pursuant to a vesting schedule that also does not violate vesting discrimination tests such as those first contained in Rev. Proc. 49, 1975-2 C.B. 584.

⁵⁹ERISA §§ 401-14.

⁶⁰ERISA § 404.

⁶¹Without an express provision allocating interest received to the borrowers plan account, an argument can be made that interest received that is greater than the return realized for plan assets in general should be credited for the benefit of all plan participants as part of the trust's overall investment performance. See *supra* note 10.

ERISA Reorganization Plan No. 4⁶² gave the Department of Labor jurisdiction over prohibited transactions issues,⁶³ the Internal Revenue Service might still be interested in the qualification impact of prohibited transactions egregious enough to merit invocation of either Code Section 401(a)(4) or the Internal Revenue Code version of the "exclusive benefit rule" set forth in Code Section 401(a)(2).

Presumably, the Internal Revenue Service would accord due consideration to the policy implicit in codifying prohibited transactions impositions separately from general plan qualification criteria in order to punish malefactors directly while preventing their shenanigans from affecting the tax benefits allowed to innocent participants. But the potential for invoking disqualification as an additional penalty may be linked to more than just the prevalence and/or degree of prohibited practices. The issue of disqualification may also present revenue enhancing opportunities in situations involving garden variety, isolated prohibited transactions violations when the impact of disqualification is little or nonexistent upon innocent participants. Thus, top heavy, and, in particular, "super top heavy"⁶⁴ plans should be viewed carefully in this regard. Loan program transgressions that also arguably involve Code Section 401(a) could lead to surprising results.⁶⁵

Prohibited discrimination and violation of the exclusive benefit rule are not the only qualification transgressions that might result from a loan program. Loans made without proper spousal consent⁶⁶ may lead to a violation of Code Section 401(a)(11).⁶⁷ Furthermore, Code Section 401(a)(13) may be violated by a plan loan not meeting a specific exemption. The exemption preventing plan loans from being deemed to involve prohibited security assignments of a participant's vested interest applies only if the loan is exempt from the prohibited transactions penalty tax imposed by Code Section 4975. Thus, prohibited transactions violations respecting participant loans have a direct impact upon the plan's qualification status in any event, unless loans are not secured with the borrower's plan interest.

A qualification criterion embodied in Treasury Regulations Section 1.401-

⁶²43 Fed. Reg. 47713 (1978).

⁶³The division of regulation did not affect the Service's implementation of the penalty tax structure of I.R.C. § 4975.

⁶⁴See I.R.C. § 416(h)(2)(B), which references the "super top heavy" standard whereby benefits for key employees exceed 90% of total benefits.

⁶⁵Under new I.R.C. § 402(b), loss of qualification will not cause tax detriment to rank and file participants, but highly compensated employees will have their entire vested accrued benefits taxed upon disqualification. Consider the impact on a plan's qualification of a situation involving a failure to grant loans to rank and file employees because a loan first given to a highly compensated employee absorbed most of the trust's liquid assets at a time after the bulk of the trust's assets were committed to highly illiquid investments.

⁶⁶See I.R.C. § 417.

⁶⁷I.R.C. § 401(a)(11) requires as a qualification criterion the creation of spousal survival interests in appropriate cases.

1(b)(1)(i) requires a *pension* plan to limit its distribution events to customary circumstances such as retirement, death, or disability. The permitted distribution events need not necessarily coincide with an offset made against a participant's vested interest upon his failure to discharge a loan obligation via regularly scheduled payments. However, Congress has stated that a deemed distribution under the Code Section 72(p) rules will not adversely affect a plan's qualified status.⁶⁸ Accordingly, security realization upon a vested accrued benefit in a pension plan arguably should not pose a qualification issue.

D. Regulation through Distributions Taxation

Even before the enactment of Code Section 72(p), it was clear that a prolonged failure to repay a plan loan, or a determination that a participant-borrower did not intend to effect repayment from the outset, could lead to a deemed taxable distribution.⁶⁹ If it can be shown that an intention not to repay a loan was conceived sometime subsequent to the granting of an initially bona fide indebtedness but prior to the plan fiduciary's realization upon security for the loan,⁷⁰ an issue respecting the proper taxable year for the participant to recognize distribution income arises.

In 1982 The Tax Equity And Fiscal Responsibility Act⁷¹ set forth the first codified rules governing the treatment of loans as taxable distributions. Code Section 72(p) limits total borrowing per participant to the lesser of \$50,000 or one-half of the participant's vested accrued benefit, while permitting loans of up to \$10,000 irrespective of the value of the borrower's plan interest.⁷² Aside from the expression of this limitation in loan provisions, most qualified plans permitting participant loans also contain language setting forth the other familiar limitation of Code Section 72(p) that requires repayment within five years, unless a "home loan" exception applies to permit a longer repayment period — presumably one consistent with commercial lending practices pertaining to home mortgages.⁷³

Like the prohibited transactions rules of Code Section 4975, Code Section 72(p) rules are not designed to affect a plan's qualification status. Violation of Code Section 72(p) will result in all or part of a loan being treated as a taxable distribution,⁷⁴ typically during the taxable year when the participant receives

⁶⁸S. REP. NO. 494, 97th Cong., 2d Sess. (1982).

⁶⁹Rev. Rul. 437, 1971-2 C.B. 185. A deemed distribution resulting from the granting of a loan under circumstances suggesting that repayment was never intended will create a qualification issue for a *pension* plan under Treas. Reg. § 1.401-1(b)(1)(i). See *supra* text accompanying note 68.

⁷⁰Inordinate delays in realizing upon security for a delinquent loan may constitute a breach of fiduciary duty.

⁷¹Pub. L. No. 97-248, 96 Stat. 324 (1982).

⁷²I.R.C. § 72(p)(2)(A).

⁷³*Id.* § 72(p)(2)(B).

⁷⁴If a \$70,000 loan is granted to a participant with a \$100,000 vested accrued benefit, a \$20,000 taxable distribution results. However, if a \$50,000 "non-home" loan is granted for a term of six years, a \$50,000 taxable distribution results.

the proceeds of a violating loan or grants security in his plan interest respecting such.⁷⁵ Thus, plan language containing the Code Section 72(p) rules is primarily intended to protect the participant from unexpected taxation.

Again, like the prohibited transactions rules, the distributions taxation rules may have some indirect effect upon a plan's qualification.⁷⁶ For example, limiting the availability and extent of loans to vested accrued benefit levels in order to conform with the Code Section 72(p)(2)(A) limitations may have the unintended result of favoring prohibited group personnel over rank and file participants in contravention of either or both Code Section 401(a)(4) and Code Section 4975(d)(1).⁷⁷

Code Section 72(p) presents a few technical problems in application: A factual determination has to be made to ascertain the valuation of a participant's accrued nonforfeitable benefit at the time a loan is made in order to see if the Code Section 72(p)(2)(A) limitations are exceeded.⁷⁸ For the same reason, factual determinations of ownership relationships among affiliated employers may have to be made if a participant is able to borrow from more than one plan.⁷⁹ Other technical concerns in the application of Code Section 72(p) will be discussed subsequently in view of the 1986 Tax Reform Act changes affecting the provision.

III. CHANGES AFFECTING PARTICIPANT LOANS UNDER THE 1986 TAX REFORM ACT

A. Direct Regulation of Loans Under the 1986 Tax Act

Code Section 72(p) as amended by the 1986 Tax Act now contains four additional restrictions governing the status of participant loans as taxable distributions.⁸⁰

First, the \$50,000 limitation of Code Section 72(p)(2)(A)(i) is reduced by a computation that refers to the highest outstanding balance of preceding loans made during the one-year period ending on the day before a proposed later loan is made. Thus, the amount one can borrow at any time is determined not

⁷⁵I.R.C. § 72(p)(1)(A)-(B).

⁷⁶See *supra* text accompanying notes 62-68.

⁷⁷Consider the situation in which all prohibited group participants are fully vested while all rank and file participants are not. Even though no vesting violation occurs under I.R.C. § 411, can allowable disparities in vesting serve as a basis for permitted discrimination in the implementation of nonvesting features of the plan, like loan provisions?

⁷⁸I.R.S. Notice 22, 1982-2 C.B. 751 states that the Service will not issue advance rulings respecting the valuation of assets securing any loan, but a valuation of the participant's interest within the last twelve months may be used, provided it is the last valuation available and is adjusted for distributions or contributions made after the valuation date. No adjustment for subsequent gain or loss need be made.

⁷⁹I.R.C. § 72(p)(2)(D).

⁸⁰H.R. REP. NO. 841, 99th Cong., 2d Sess. (1986) designates Section 1134 of the bill as "Treatment of Loans." That section sets forth the I.R.C. § 72(p) amendments, made effective for loans made, renewed, renegotiated, modified, or extended after December 31, 1986.

only by the outstanding balance of loans existing at the latest borrowing date but also by any prior outstanding loan balance if such is higher than that existing at the latest borrowing date. This means that a participant would not be able to borrow the full \$50,000 maximum unless he had a vested accrued benefit of at least \$100,000⁸¹ and had fully paid all previous loans from the plan more than one year prior to the current borrowing. The effect of this provision is to prevent repetitive borrowing-repayment cycles, separated only by short intervals, that might otherwise thwart the requirement that loans be repayable within five years.⁸² Such loan cycles were possible under prior law respecting any participant (perhaps most commonly one who had access to the assets of a controlled business) who could make a short term commitment of the cash necessary to effect a loan repayment just prior to the next reborrowing of that same cash. The one-year "lookback" period now requires the inconvenience of committing the cash to the plan for at least a year prior to reborrowing it.

In coordination with the one-year "lookback" rule, the second restriction added to Code Section 72(p) requires that loans be repaid with substantially level amount payments made not less frequently than quarterly over the term of the loan.⁸³ This rule prevents "balloon" repayments, such as would assist one in effecting the form of perpetual reborrowing just mentioned. Aside from its role in preventing perpetual reborrowing, the level amortization requirement may tend to reduce loan defaults, or at least encourage participants to think of plan loans as they would regard regular commercially granted borrowing. In any event, level repayment amortization permits plan fiduciaries to spot, and act upon, problem loans earlier.

Although Code Section 72(p) allows no exception to the level amortization rule on its face, the Conference Agreement Report⁸⁴ states the intention of the conferees that the level amortization requirement does not apply to a period when the employee is on a leave of absence without pay for up to one year. Plan administrators disposed toward incorporating this uncodified exception into their revised plan loan provisions can, of course, test the Internal Revenue Service's acceptance of the conferees' intended exception through the determination letter process.⁸⁵ The conferees also mention that the level amortization rule does not preclude repayment or acceleration of the loan prior to the end of the commitment period. Thus, loan provisions permitting prepayments or requiring full repayment upon the occurrence of some event, like default or termination of employment, would not be adversely affected.⁸⁶

⁸¹I.R.C. § 72(p)(2)(A)(ii).

⁸²*Id.* § 72(p)(2)(B)(i).

⁸³*Id.* § 72(p)(2)(c).

⁸⁴H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. (1986).

⁸⁵Qualified plans will have to be amended and resubmitted for new determinations in due course as a result of the 1986 Tax Reform Act. Act § 1140 requires plan amendments to be made no later than the last day of the first plan year beginning on or after January 1, 1989.

⁸⁶As mentioned previously, properly authorized payroll withholding is an effective means to ensure repayment.

The third change in Code Section 72(p) might logically have been inserted in Code Section 163 instead, since the latter sets forth the bulk of rules governing the deduction of interest paid or accrued on indebtedness.⁸⁷ Code Section 72(p)(3) denies deductions for interest paid or accrued respecting participant loans made to a key employee as defined in Code Section 416(i)⁸⁸ or secured by amounts attributable to elective Code Section 401(k) or 403(b) deferrals. The Conference Agreement emphasizes that a participant may not increase his basis in his plan benefit and thus effect a mere deferral of the denied interest deductions, as was originally proposed under the House Bill.⁸⁹ The interest deduction is lost forever, if indeed it could have been sustained under the general limitations on interest expense deductions found in the Code both prior and subsequent to enactment of the Tax Reform Act of 1986.⁹⁰

Of course, Code Section 72(p)(3) has no effect on regular rank and file participants of Code Section 401(a) plans. The provision likewise does not affect key employees of such plans who would not otherwise be able to deduct interest paid due to insufficient itemized deductions or other tax posture features.⁹¹ For those key employee participants in Code Section 401(a) plans and all participants in plans permitting elective deferrals who found abiding economic solace in plan loans,⁹² the loss of interest deductions will no doubt be regarded as a catastrophic occurrence that discourages continuance of plan loan provisions.

The fourth revision of Code Section 72(p) provides that loans for terms greater than five years are permitted only if the loan is "used to acquire any dwelling unit which within a reasonable time is to be used (determined at the time the loan is made) as the principal residence of the participant."⁹³ The Conference Report states that it follows the House bill respecting the principal residence exception to the five-year repayment rule, and the Conference Report refers to the now outlawed practices of granting longer term loans to improve an existing principal residence, purchase a second home, or finance the purchase of a home or home improvements for other members of the employee's family.⁹⁴

⁸⁷Respecting loan interest deductions generally, see *infra* text accompanying notes 107-23.

⁸⁸I.R.C. § 416(i) generally defines "key employee" in relation to officer status, compensation, and ownership interests in the employer. Unfortunately, the prohibited group concept of I.R.C. § 401(a)(4), although encompassing the same concepts, does not give us an identical definition. Furthermore, the 1986 Tax Act definition of "highly compensated employee" expressed in new I.R.C. § 414(q) fails to create uniformity of definition with I.R.C. § 416(i), leaving practitioners to struggle again with two similar but nonidentical definitions of participants not to be considered among the rank and file of employees.

⁸⁹H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. (1986).

⁹⁰See I.R.C. § 163.

⁹¹Under the 1986 Tax Reform Act itemized deductions will have to exceed \$5,000 in 1988 for married persons filing a joint return before tax liability is reduced. I.R.C. § 63.

⁹²See *supra* text accompanying notes 1-16.

⁹³I.R.C. § 72(p)(2)(B)(ii).

⁹⁴H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. (1986).

Preserving the exception for the benefit of participants who wish to help finance the acquisition of a principal residence with plan loans represents a minor tax policy concession that encourages widespread home ownership. However, in doing so, Congress has left taxpayers with the potentially sticky factual determinations of what a "reasonable time" is to effect the qualifying use (presumably a question likely to be invoked in new construction situations or when the acquiring participant delays occupancy pending disposition of a preceding rental term of an occupying tenant) and the well-worn question of what constitutes the taxpayer's principal residence.⁹⁵ Also, the parenthetical clause "(determined at the time the loan is made)" presents a somewhat cryptic meaning. Apparently, the clause modifies the words "to be used" immediately preceding it and thus calls for a determination of intended use at the time the loan is made. Does this permit the borrower to change his mind after the dwelling is acquired and thereby rent the premises to another person instead of occupying it himself, as long as he intended to use the dwelling as a principal residence at the time the loan was made? If so, we are left with a subjective intent determination that may be quite difficult to establish.

A plan administrator wishing to avoid such interpretive problems could simply arrange to re-draft the plan's loan provision so as to limit *all* plan loans to five-year terms. Doing so would not necessarily discourage all plan borrowing respecting the acquisition of a principal residence. Usually, plan monies are looked to by participants either as a potential source of all or part of a downpayment or as a source of "bridge" financing that permits acquisition of a new home prior to selling a former residence. The latter need for plan loans would most likely be fulfilled well within a five-year period.⁹⁶ The ability to replace "downpayment" financing within five years would be present once a home's appreciating value permits a later second mortgage to be given or when the participant's increasing earning power allows other substitute financing.

In addition to the changes made to Code Section 72(p), the 1986 Tax Reform Act directly affects plan loans in Act Section 1898, which provides technical corrections to ERISA and the Retirement Equity Act of 1984.⁹⁷ Section 1898(i) of the Tax Reform Act of 1986 creates the potential for owner-employees (partners and self-employed persons)⁹⁸ to receive prohibited transactions exemptions for plan loans granted to such individuals. Under ERISA Section 408(a) the Secretary of Labor, in coordination with the Secretary of the Treasury, can establish exemption procedures to grant conditional or unconditional exemptions upon finding that an exemption is administratively feasible, in the interest of plan participants and beneficiaries, and otherwise protective

⁹⁵The issue arises under I.R.C. § 1034 involving rollover of gain on the sale of a principal residence.

⁹⁶That is, the homeowner-borrower is likely to obtain the equity from his old residence by selling it, usually no later than a few months after acquiring a new residence, and thus terminate relatively promptly the need for interim financing.

⁹⁷Pub. L. No. 98-397, 98 Stat. 1426 (1984).

⁹⁸See I.R.C. § 401(c)(3) for the technical definition of "owner-employee."

of the rights of such participants and beneficiaries. The statute sets forth its own procedures for exemption, which consist of publication of prior notice in the Federal Register, adequate notice to interested persons, and opportunity for a hearing that permits interested persons a chance to present views, thus affording a record-based determination.

There is no ready way to know when or if the Departments of Labor and the Treasury will implement their own procedures to accompany those statutorily mandated. Plan loans to partners or self-employed participants are likely to remain prohibited, at least in a practical sense.

Even if full exemption procedures were available, the economic value of plan loans to owner-employees is unlikely to outweigh the costs and bother associated with the implementation of an exemption request. This is particularly so in consideration of the Code Section 72(p)(3) denial of interest deductions for key employees. The fiduciary responsibility implications raised by the ERISA Section 408(a) exemption criteria present an additional barrier to such loans. Would the granting of loans to owner-employees work in the interest of all plan participants and beneficiaries? It is probably easier to think of ways in which owner-employee loans work to the detriment of those who are not owner-employee participants than to find arguments supporting an affirmative answer to this question.⁹⁹

Also, Section 1898(i) of the 1986 Tax Reform Act, while amending ERISA to make the prohibited transactions exemption theoretically possible, does not amend Code Section 4975, which continues to deny exemption for participant loans involving owner-employees.¹⁰⁰ Thus, the penalty tax on prohibited transactions still accompanies such loans, although a conforming amendment to Code Section 4975 may be contained in a later technical corrections act. Plans having owner-employee participants can, as always, contain provisions permitting loans for those who are not owner-employee participants. Such provisions are no doubt relatively rare, since there is little or no incentive for the owners of a non-incorporated business to undertake administration of a plan feature that does not personally benefit them. The existence of such provisions is predicated entirely upon the owner's willingness to complicate plan administration in order to provide an ancillary credit convenience for rank and file employees.

Section 1898 of the 1986 Tax Reform Act further directly addresses participant loans in the context of the survivor annuity rules contained in the Retirement Equity Act of 1984.¹⁰¹ The survivor annuity rules generally require written spousal consent, including a formal verification of the spouse's

⁹⁹It may be asserted, for example, that such loans would restrict the investment opportunities or liquidity of the qualified trust.

¹⁰⁰I.R.C. § 4975(d).

¹⁰¹See generally I.R.C. § 417.

signature, in order to effect a waiver of the qualified joint and survivor annuity or qualified preretirement survivor annuity normally given to a surviving spouse as a matter of right.¹⁰² Since using one's vested accrued benefit as security for a plan loan could result in a security realization upon default and thus a disposition of at least part of the participant's plan interest contrary to the rights of a potential surviving spouse, the question of securing spousal consent in connection with the granting of participant loans arose immediately upon enactment of the Retirement Equity Act of 1984.

The first response to this question came in the form of temporary regulations stating that although a loan to a participant is not per se to be treated as a distribution permissible only upon the prior obtaining of spousal consent, the reduction of an accrued benefit in satisfaction of an unpaid loan obligation would be so treated.¹⁰³ Even though spousal consent was not required at the time a loan was made, it would be required prior to security realization. If the spouse was not willing to consent at the later time, the loan would in effect be inadequately secured in violation of Code Section 4975(d)(1)(E).¹⁰⁴ This predicament placed a premium on obtaining spousal consent at the time the loan was made.

Section 1898(b) of the 1986 Tax Reform Act alters this situation by requiring that if the Code Section 401(a)(11) survivor rights provision applies to a participant when his accrued benefit is to be used as security for a loan, such use for security will be denied unless spousal consent has first been obtained.¹⁰⁵ Since certain profit-sharing plans are exempt from the Code Section 401(a)(11) requirements,¹⁰⁶ they will not need to have loan provisions requiring spousal consent. Conveniently, the new law focuses on the participant's status at the time his plan interest is first used as security (usually upon distribution of loan proceeds). This eliminates problems that might otherwise arise by virtue of a later change of spousal status, such as occurs when an unmarried person acquires a spouse subsequent to taking out a loan, or when a divorced participant-borrower subsequently acquires a new spouse.

B. Indirect Regulation of Loans Under the 1986 Tax Act

Perhaps the most substantial indirect effect on plan loans occasioned by the Tax Reform Act of 1986 results from new restrictions on the deductibility of interest paid or accrued. Beyond the Code Section 72(p)(3) interest deduction prohibitions, Code Section 163(h) denies deductions for interest paid on plan loans if such constitutes "personal interest" paid or accrued during the

¹⁰²I.R.C. § 417(a)(2)(A).

¹⁰³Temp. Treas. Reg. § 1.417(e)-1T(d).

¹⁰⁴See *supra* text accompanying notes 56-57 (regarding the adequate security requirement for plan loans).

¹⁰⁵Pub. L. No. 99-514, § 1898(b)(4), 100 Stat. 2085, ___ (1986).

¹⁰⁶See I.R.C. § 401(a)(11)(B)(iii).

taxable year. Reminiscent of the manner in which the Internal Revenue Code defines a capital asset in Code Section 1221, "personal interest" is defined as *any* interest other than interest that can be characterized as fitting certain listed descriptions.¹⁰⁷ Four of the listed descriptions could be of potential use to a plan participant who borrows from a qualified trust: interest on loans taken in connection with a trade or business other than employment; interest on debt taken to support an investment;¹⁰⁸ interest taken into account under Code Section 469 in computing income or loss from a passive activity of the taxpayer;¹⁰⁹ and "qualified residence interest."

The first three of these four interest characterizations can be used by a non-key employee borrower to achieve planned deductions respecting loans deliberately taken to apply the loan proceeds toward a qualifying activity or investment. As a practical matter, the combination of the Code Section 72(p)(3) restriction applicable to key employees and the three mentioned interest deduction characterizations is likely to promote loan taking by participants who are highly-compensated but not key employees as defined in Code Section 416(i). Rank and file participants not able to get interest deductions for loans taken in connection with personal expenditures may be driven to borrow instead from sources that permit interest deductions, such as home-equity lines of credit offered by commercial lenders. Accordingly, it is conceivable that some plans that implement or continue loan provisions in the future may grant more loans to non-key employees who are also highly-compensated and thus more likely to afford debt connected with ancillary trades or businesses, investments, or passive income-producing activities.

Under such circumstances, could a loan provision in operation tend to discriminate in favor of "prohibited group" employees, or after December 31, 1988 "highly compensated employees"¹¹⁰ in violation of the qualification edict of Code Section 401(a)(4), or perhaps even in violation of the prohibited transactions exemption requirement of Code Section 4975(d)(1)(A) or (B)?¹¹¹ If so, we have yet another unfortunate consequence of the failure of the new act to conform the key employee/prohibited group/highly compensated employee definitions.¹¹²

In any event, all participants, except key employees but including no doubt substantial segments of the rank and file, might benefit from a plan loan

¹⁰⁷I.R.C. § 163(h)(2)(A)-(E).

¹⁰⁸Such interest, under I.R.C. § 163(d)(1), is deductible only to the extent of the taxpayer's investment income for the taxable year. *See* I.R.C. § 264 respecting the total nondeductibility of interest incurred in connection with certain insurance contracts.

¹⁰⁹I.R.C. § 469 limits the immediate tax utility of such interest in relation to the amount of passive income generated by or on behalf of the taxpayer.

¹¹⁰I.R.C. § 414(q).

¹¹¹*See supra* text accompanying notes 38-61 (section designated "Prohibited Transactions and Fiduciary Responsibility Regulation").

¹¹²*See supra* note 88.

provision that creates interest payments deductible under the “qualified residence interest” characterization. In order for a plan to permit qualified residence interest on a plan loan, the debt must be secured by a security interest perfected under local law in the taxpayer’s principal residence or a second residence.¹¹³ Shifting the trust’s security interest from the participant’s accrued benefit to his equity in his residence would constitute a major administrative change under virtually all plan loan provisions in effect upon enactment of the Tax Reform Act of 1986.

No doubt it is much easier for a plan administrator to arrange a security interest in a participant’s plan interest than in his home equity. The latter requires most or all of the administrative costs and procedures associated with regular mortgage lending — inspections, approvals, appraisals, title searches, and the like. Although commercial mortgage lenders may find it profitable to deal with such items, plan administrators will likely be less than enthralled with the prospect of assuming these banker’s burdens. Consequently, plan loans are likely to result in quite limited future interest deductions.¹¹⁴

As mentioned in connection with the Code Section 72(p)(3) limitation on interest deductions, the issue of interest deductions is, of course, inconsequential to taxpayers whose tax postures make such deductions useless even if allowable. In this regard, the effect of the new act in reactivating and increasing the standard deduction,¹¹⁵ increasing personal exemptions, and altering the usefulness of certain itemized deductions¹¹⁶ may be noted, since the effect of these changes will be to increase the number of taxpayers who will find itemization of deductions non-productive. It may be noted further that interest payments respecting personal indebtedness continue to have no beneficial effect under many state and local taxing schemes.

In addition to its interest deduction limitations, the 1986 Tax Act contains a few other changes affecting participant loans. To the extent that the new minimum participation rules¹¹⁷ expand the number of participants in a particular plan permitting loans, the number of loans and associated administrative burden for such plan will likely also increase. Similarly, new rules accelerating vesting¹¹⁸ and conferring greater accrued benefits notwithstanding Social Security integration¹¹⁹ will permit greater and earlier borrowing potential under most loan provisions.

¹¹³H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. (1986).

¹¹⁴The denial of deductions for personal interest is phased-in over a four-year period beginning in 1987. See I.R.C. § 163(h)(6).

¹¹⁵I.R.C. § 63(c).

¹¹⁶Note the two percent of adjusted gross income floor placed under miscellaneous itemized deductions by I.R.C. § 67(a).

¹¹⁷See I.R.C. § 410(b) effective for plan years after December 31, 1988.

¹¹⁸See I.R.C. § 411(a) effective for plan years after December 31, 1988.

¹¹⁹See I.R.C. § 401(l) effective for plan years after December 31, 1988.

Code Section 415(c)(2) as amended by the 1986 Tax Reform Act defines a participant's annual addition subject to limitation as including all employee contributions rather than only employee contributions that exceed an alternative limit.¹²⁰ Consequently, increased levels of employee contributions now create a greater threat of violating Code Section 415. Deemed-but-not actual distributions under Code Section 72(p) may be followed by loan repayments that should be regarded as employee contributions in order to prevent taxation on such repaid amounts upon later distribution. Using the employee contribution concept would thus prevent double taxation, but do such constructive employee contributions have an effect on the Code Section 415 limitation? The legislative history for the 1982 Tax Equity and Fiscal Responsibility Act makes it clear that although such repayments are to be regarded as employee contributions for the purpose of preventing double taxation subsequent to a deemed Code Section 72(p) distribution, they are not to be so considered for Code Section 415 purposes.¹²¹ This should continue to be so under the 1986 Tax Reform Act.

Later distributions of repayments deemed to be employee contributions by virtue of a constructive distribution under Code Section 72(p) may not be made entirely tax-free under the new act. Code Section 72(b) will apparently require that a redistribution of previously taxed amounts will be subject to tax proportionately in accordance with the ratio of employee contributions to the total accrued benefit.¹²² In other words, to some substantial extent such redistributions would be likely to carry out to the taxpayer previously untaxed deferred compensation.

The new act presents one further complication in connection with imposition of a deemed distribution occasioned by either operation of Code Section 72(p) or default upon a loan otherwise meeting the Code Section 72(p) requirements. If the participant is under age 59½ and otherwise fails to meet the conditions set forth in Code Section 72(t),¹²³ his taxable distributions will be subject to a 10% additional tax on early distributions from qualified retirement plans.

CONCLUSION

The 1986 Tax Reform Act changes affecting plan loans further restrict the usefulness of such loans for employees who control or manage employers and thus create new disincentives against the implementation or continuance

¹²⁰I.R.C. § 415(c)(2) formerly included in the annual addition only the portion of employee contributions that exceeded the lesser of one-half of a participant's employee contributions or the amount by which the participant's employee contributions exceeded six percent of the participant's compensation for the limitation year.

¹²¹H.R. CONF. REP. NO. 760, 97th Cong., 2d Sess. (1982).

¹²²Previous law permitted total recovery of nontaxable employee contributions prior to receipt of amounts as to which tax had been deferred.

¹²³See I.R.C. § 72(t)(2)(A).

of loan provisions in qualified retirement plans. The economic advantages of plan loans are not always evident in any event. Any remaining conveniences of plan loans are rapidly being outweighed by increasing administrative burdens in many instances. Nevertheless, many plan administrators will have to continue struggling with these increasing administrative burdens, since even plans that discontinue granting new loans will have to administer existing loans for whatever period is necessary to effect final repayment of all outstanding loan balances. Also, some large plans may continue loan programs solely as a convenience to (or in fulfillment of the expectations of) rank and file employees or even highly compensated employees still allowed interest deductions. Consequently, the various direct and indirect regulatory aspects of plan loans continue to be of interest to many retirement plan advisors and administrators.

